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Financial services

Regulation

Banking

A case for proportionate regulation

A positioning paper

August 2018

This paper has been commissioned by the Customer Owned Banking Association (COBA) on behalf of the customer owned banking sector, comprising mutual banks, credit unions and building societies with total assets in excess of $111 billion and more than 4 million customers.

Customer owned banking institutions are:
- ADIs, regulated and supervised by APRA
- AFS licensees regulated by ASIC
- credit licensees regulated by ASIC
- AML/CTF reporting entities, regulated by AUSTRAC.

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Foreword

2018 has been a pivotal year for Australia's financial services industry.

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The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry began hearings in March, receiving more than seven thousand submissions with 65% focusing on Authorised Deposit-taking Institutions (ADIs). The Commonwealth Bank Prudential Inquiry report was released in April and provided a strong case for increasing focus on risk culture, governance and accountability within financial institutions. And the Productivity Commission Inquiry into Competition in the Australian Financial System final inquiry report was handed to the Australian Government on 29 June 2018 and tabled on 3 August 2018 after four public hearings, 137 submissions, several roundtables and discussions with various stakeholders including industry bodies, businesses, financial regulators, regional banks, consumer groups, academics and government agencies.

The long term outcome of all of this activity is also still relatively unknown, but it is highly anticipated to result in an increase in regulation across the Australian financial services industry. What we know about increased regulation, in both Australia and overseas, is that it comes with increased costs in terms of skills required, bodies on the ground, time to address new requirements and the hardware and software to make it all run smoothly.

This cost is easily absorbed by larger ADIs – the big banks – but can put undue pressure on the smaller ADIs – such as customer owned institutions – that strive to compete in an environment where the cost of compliance is already burdensome, and the changing nature of technology continues to strain resources.

We should also bear in mind that the business model for the big banks and customer owned banks are considerably different. Customer owned banks typically return 100% of profits to members in the form of reinvestment back into their local communities or as better rates and reduced fees. With profits already spoken for, there isn't as much wriggle room for reapportioning or taking on additional resources to comply with additional regulation as the bigger banks.

This is the time to revisit the case for proportionate regulation across the financial sector, with consideration to all changes including prudential, conduct, industry, data and competition requirements. Change is coming from all directions and without due consideration and planning it could have significant impact on smaller ADIs.

Not a new concept, the Basel Framework consistently applies principles of proportionality, taking into account qualitative and quantitative criteria such as a bank's size and risk profile, the complexity of its activities and its international presence. How this is applied in practice has varied.

The current regulatory agenda has seen areas where proportionality has been considered for smaller ADIs such as the timeframes to comply being extended for both the Banking Executive Accountability Regime (BEAR) and the Open Banking Regime and also the proposal of a simplified framework for regulatory capital for smaller institutions. However, additional changes relating to dispute resolution, credit card reforms, design and distribution obligations and also the requirements set out in the draft CPS234 Information Security appear to apply to all, regardless of size. Time will tell how much further regulatory change is introduced as a result of the findings of the Royal Commission.

Several countries have applied proportional approaches to regulation which allow regulatory relief for smaller institutions that are often limited by the financial costs of high levels of compliance. As stated in the Guide to Better Regulation[1] 'a culture of innovation can be supported by ensuring that regulation is fit for purpose in the digital age, and by ensuring fair and proportionate regulation that offers the right levels of protection for the community'.

An outcome focused lens, rather than a prescriptive approach will benefit in creating a more equitable industry where smaller ADIs do not have the burden of regulation that limits their ability to compete and provide increased community choice.

This is the time to revisit the case for proportionate regulation across the financial sector, with consideration to all changes including prudential, conduct, industry, data and competition requirements.

1. Guide to Better Regulation, October 2016, NSW Government Department of Financial Services and Innovation http://productivity.nsw.gov.au/sites/default/files/2018-05/Guide_to_Better_Regulation-October_2016.pdf

There is an undeniable knock on effect of regulation

Since the global financial crisis there has been increased scrutiny placed on financial institutions worldwide. This has resulted in an increase in regulation which has often disproportionately impacted smaller ADIs in terms of cost.

Like any other organisation, ADIs make choices regarding investments focussed on growth, innovation and general improvements. However, no choice exists in relation to when investments are required to meet regulatory requirements.

These obligations cannot be deferred, and the associated costs are the same no matter the size of the ADI – the going rate is the going rate – and this reapportioning of funds to meet new requirements will ultimately limit the investment available for innovation and growth.

As outlined earlier the costs associated with the human resources and new technology required to comply with enhanced reporting requirements is relatively fixed so the size of the ADI does little to lessen that burden.

In its submission to the Productivity Commission, the largest customer owned banking institution CUA stated:

"The increasing rate of regulatory change and speed of innovation in the sector means many mutual organisations need to focus on playing catch up to meet the widening technical capability gap. They are doing this by investing capital in areas such as optimising core banking systems and enhancing loan origination systems. This means they do not have the time, financial or human resource to focus on opportunities for collaboration and innovation beyond business as usual." (CUA, sub. 15, p. 3)

In addition to limiting opportunities for growth, there is the real downstream impact on consumers who will shoulder some of the burden of the cost of compliance.

Commonwealth Treasury's July 2018 submission on key policy issues to the Financial Services Royal Commission stated:

"Regulatory costs are borne by financial firms and, in turn, by consumers either directly through higher costs for financial products and services, or indirectly through the impact of such costs on competition or innovation in the choice and quality of products and services that consumers can access."

"Regulatory costs impact all firms but can have a disproportionate impact on smaller firms and new entrants."

It was highlighted during the recent Productivity Commission Inquiry into Competition in the Australian Financial System that regulatory costs are often passed to the customers.

In its submission to the Productivity Commission APRA stated:

"APRA does not interpret its mandate as requiring it to assess the potential impact of a regulatory proposal on the ultimate price paid by consumers for financial products." (APRA, sub. DR116, pp. 8–9)

Considering the smaller margins that smaller ADIs operate with, this approach from APRA inevitably places smaller ADIs at a disadvantage compared to their larger counterparts. In isolation many of the changes appear immaterial however, the combined impact of the regulatory change is substantial for smaller ADIs. In addition, this blanket approach would result in a poorer outcome for customers that benefit from the reinvestment in the community and better deals and customer service that customer owned banks are well known for.

Based on economies of scale and value provided to the community, an approach to regulation which is proportionate based on risk profile, asset composition and size is wholly appropriate.

The right levels of protection for the financial system as a whole, needs to be balanced with the availability of choice to consumers, as choice is an enabler of long-term growth and innovation in the market. Regulation should be targeted to accommodate different ADIs by size, risk profile, complexity and business model which will allow ADIs to compete on a fairer playing ground.

How has this been done elsewhere?

The European Banking Authority (EBA) has developed guidelines for the supervisory review and evaluation process (SREP) which is an annual review of an institution which summarises the supervisor's assessment and findings and sets objectives for the bank to achieve within a specific time to address identified issues. The process is designed to be holistic, taking into consideration the bank's entire risk profile including capital, liquidity, governance and risk, and business model.

These SREP guidelines recognise the principle of proportionality by:

a. categorising institutions (in four distinct categories) according to their systemic importance and the extent of any cross-border activities
b. building a minimum supervisory engagement model, where the frequency, depth and intensity of the assessments vary depending on the category of the institution.

This approach highlights an acknowledgment of the diversity within the Banking Sector in Europe and the need to view institutions from a broader view taking into consideration elements such as their individual complexities, systemic importance, status within a group structure, strategies, governance etc.

Read more
Guideline on Common Procedures and Methodologies for the Supervisory Review and Evaluation Process (SREP)

The Financial Stability Institute (FSI) at the Bank for International Settlements (BIS) distinguishes between the following two approaches in implementing proportionality in selected regional jurisdictions

Categorisation Approach for Proportionality (CAP)

Banks are categorised by various qualitative and/or quantitative characteristics – with size being the decisive characteristic as a rule – and a specific regulatory regime is applied to each of the categories.

Specific Standard Approach for Proportionality (SSAP)

Tailored criteria are established for the application of specific requirements for a subset of prudential standards, such as disclosure requirements, liquidity indicators, large exposure limits and market risk.

Applicable countries

Go to publication

"One of APRA's constant challenges is balancing two competing demands: a desire for a regulatory framework that appropriately differentiates across the diversity of ADIs, and (simultaneously) a desire to avoid differences in regulation creating competitive inequalities when different classes of ADIs compete against each other. Put more simply, there are few advocates for a 'one size fits all' approach, but equally everyone wants a level playing field."

Wayne Byres, APRA Chairman - Keynote address at Customer Owned Banking Convention, Brisbane 23 October 2017

Read full speech

The cost of doing business

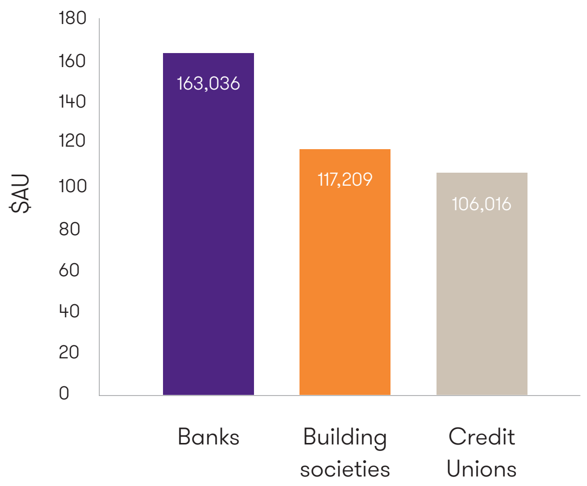
Technology

Ongoing success in the banking sector is increasingly dependent on the scale of investment in technology. Technology allows ADIs to meet regulatory reporting requirements, deliver services more efficiently and expand their reach through internet and mobile banking platforms and payment systems. These platforms and systems often require ongoing additional funds to be invested for maintenance, updates, security and the rollout of new features.

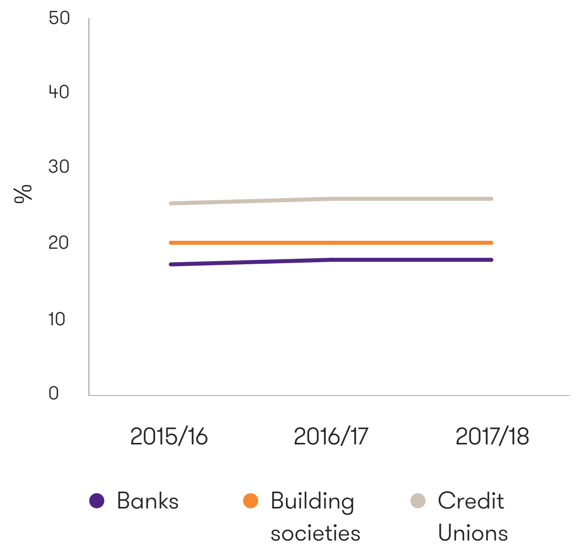
Labour

The largest non-interest expense for an ADI is labour and is represented by wages. Although many ADIs outsource a number of roles, face-to-face customer staff remain vital for maintaining customer satisfaction. According to IBISWorld's 2018 industry reports[2] the average wage within banks was just over $163,000, with building societies at just over $117,000 and credit unions at $106,000.

Average wage comparison



Cost of wages as a percentage of revenue



2. IBISWorld Industry Report K6222, Building Societies in Australia, May 2018; IBISWorld Industry Report K6223, Credit Unions in Australia, February 2018; IBISWorld Industry Report K6621a, National and regional commercial banks in Australia, June 2018.

As an illustration of the personnel costs of regulatory compliance, consider the recommendation of the Productivity Commission that all ADIs appoint a Principal Integrity Officer (PIO). The PIO would have independent status within the entity and a direct reporting line to its Board. It would be expected that the PIO would hold executive status within an organisation and therefore the salary afforded to such a role would be well above the average wage.

For the major banks with an average of 39,757[3] full time employees, the appointment of another executive may not have a major impact but for smaller ADIs, some with as little as 19[4] employees, this can have significant implications in terms of additional cost. Furthermore, sourcing an individual with the skills required in regional areas may be difficult.

If the PIO idea is adopted, it is hoped that the government will apply a proportional approach in order to ensure smaller institutions are not unduly effected by the obligation.

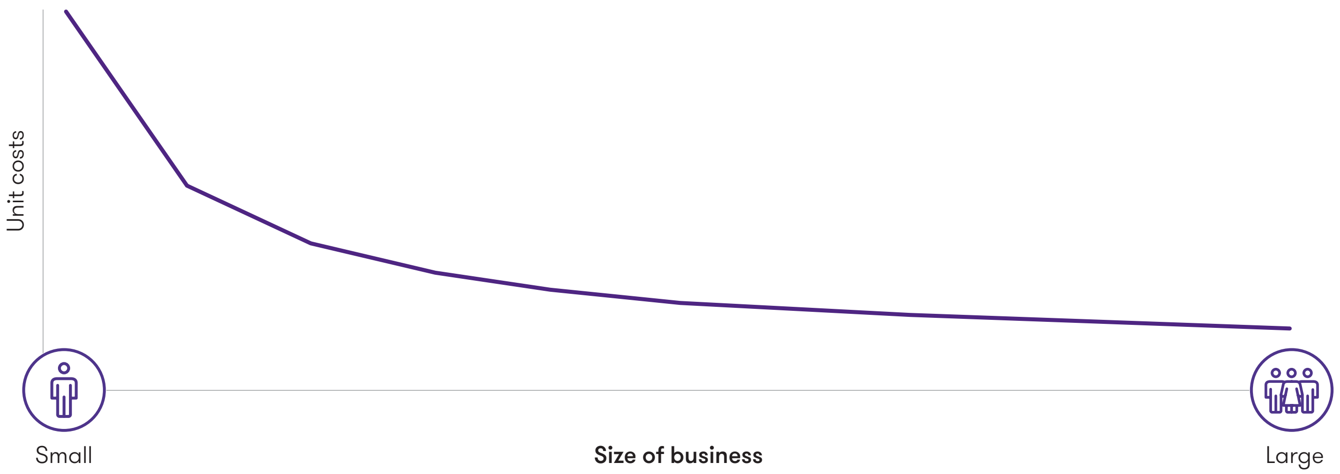
Thought should be given to extending the responsibilities of current positions, such as the Head of Internal Audit[5] who has an existing requirement of independence.

Fixed costs

The fixed costs of regulation follow the same economic rules as all other fixed costs. That is, larger ADIs will experience a lower proportional cost as they are able to spread the fixed costs across a larger number of customers. Whether the regulation requires for investment in technology or labour, the proportional cost will be higher the smaller the ADI.

Overall, the cost of compliance is more easily absorbed by larger ADIs – the big banks – but can put undue pressure on the smaller ADIs that are seeking to compete in an environment where the cost of compliance is already burdensome, and the changing nature of technology continues to strain resources.

Compliance costs of regulation and business size (stylised)[6]



3. Employee numbers taken from the 2017 Annual Reports of CBA, NAB, Westpac & ANZ
4. http://www.bhccu.com.au/about/what-were-all-about/
5. As outlined in CPS510 Governance https://www.legislation.gov.au/Details/F2016L01432/Html/Text#_Toc461117218
6. Regulation and small business, August 2017, Australian Government Treasury, https://treasury.gov.au/publication/p2017-t213722a/

Don’t we have proportionate regulation already?

While some effort to acknowledge these differences in Australian ADIs has been implemented (eg PAIRS and SOARS ratings), there is still room for a more transparent, consistent and formalised approach to the categorisation of institutions.

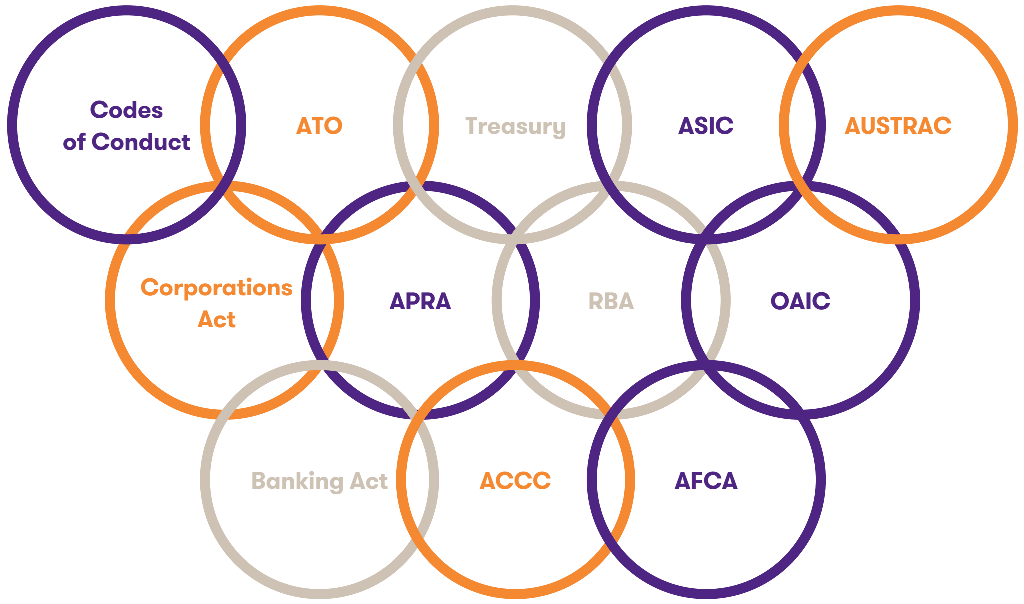
For instance, the 2014 Murray Financial System Inquiry considered the impact of compliance costs and regulatory processes on institutions and recommended an increase in the time available for entities to implement complex regulatory change.

This resulted in extended timeframes for smaller ADIs to comply with new requirements such as BEAR and the Open Banking Regime. The additional time is highly valued by smaller ADIs and is a sign that regulators are considering a proportionate approach in some areas.

Further to this recommendation it was suggested that there should be more frequent post-implementation reviews of major regulatory changes to ascertain cost effectiveness and help develop better processes for future interventions. This Government did not agree with this recommendation due to changes which had already been implemented.

With regulation change on the horizon, this is the time to assess what has been working, what hasn’t, and to put in place the right framework which will both protect consumers and foster a banking sector that is genuinely competitive and provides real choice for all Australians.

The complexity of requirements and obligations for ADIs in Australia

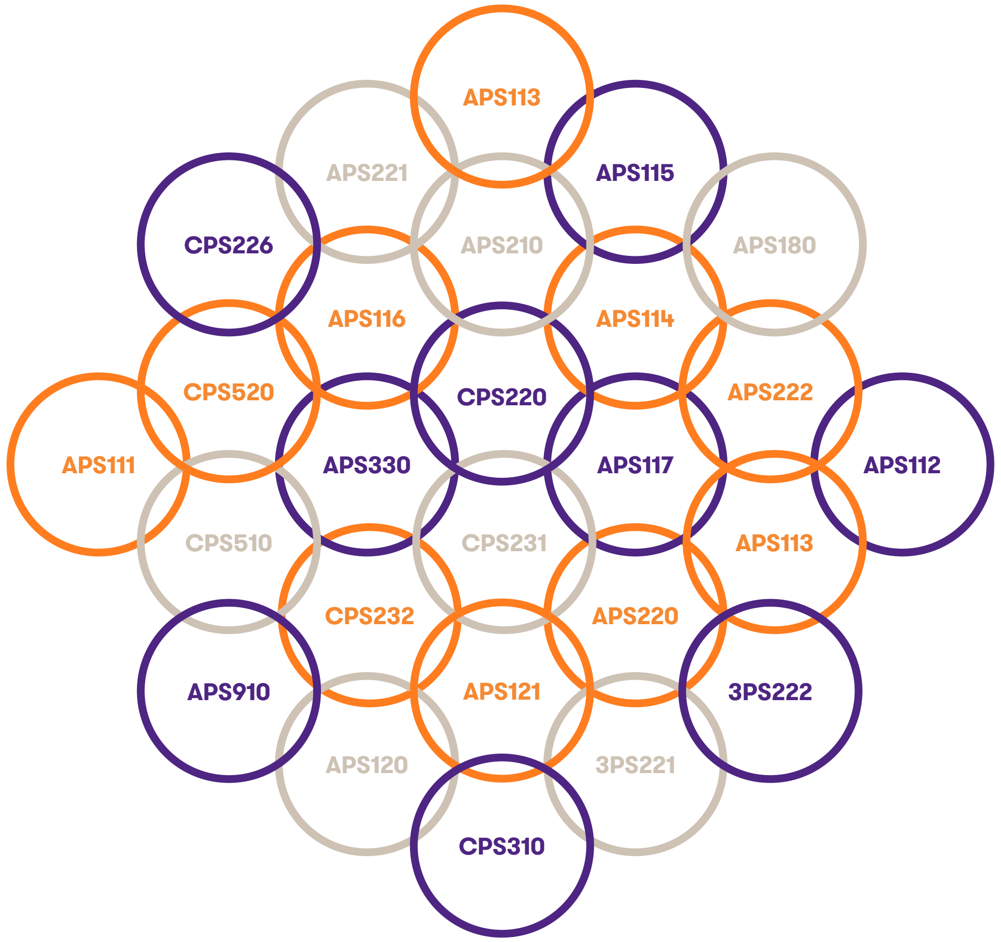


In APRA's discussion paper, Revisions to the capital framework for authorised deposit-taking institutions, from 14 February 2018, APRA stated that:

"[p]roportionate and tailored requirements for small ADIs could reduce regulatory burden without compromising prudential safety and soundness." Chapter 8 of the paper outlined a proposal for a simplified capital framework for smaller ADIs which would "be broadly aligned to the more complex regulatory capital framework, yet would be designed to suit the size, nature, complexity and risk of small ADIs."

This was seen as a move in the right direction but there is still a long way to go in terms of proportionality.

APRA's regime includes multiple prudential standards – each with the force of law – on capital, governance, risk management, reporting and other requirements.



An example of the prudential standards provided by APRA that the banking sector currently adheres to. This does not include taxation requirements or other standards from other regulatory bodies, including ATO, ASIC etc

The key to proportionate regulation is the differentiation of entities and the understanding of those differences. Merely dividing a group based on asset size is not enough, a deeper understanding of the business model and drivers is required in order to fully assess the viability, sustainability and vulnerabilities of the entity.

Key differences for smaller ADIs against the larger entities which should be considered include the absence of shareholder returns, lack of vertical integration, smaller range of products and services and the systemic impact they pose on the industry as whole.

> "Measured relative to assets, mutuals generate higher net interest income, and higher total income, than the four major banks that dominate the industry. Unfortunately, the much higher cost base more than offsets that advantage.

Wayne Byres, APRA Chairman – Keynote address at Customer Owned Banking Convention, Brisbane

Read full speech

How has this been done elsewhere?

De Nerlandsche Bank released a comprehensive research paper on proportional and effective supervision in the Dutch financial services sector. Released in 2018, the report aims to help identify the unintended effects of new regulation at an early stage and propose concrete policy actions to mitigate them.

Key findings from the research include:

a. there is room for improving proportionality in regulation and supervision
b. while proportionality can lead to simpler rules for small or less complex institutions, these should not be less stringent
c. while stricter rules make individual institutions safer, there are indications of increased homogeneity
d. more diversity at a sector level contributes to reducing systemic risk.

Many of the issues highlighted in this paper are ones that Australia will have to face post Royal Commission.

Read more
Proportional and Effective Supervision

Social licence to operate – what value do we place on giving back to the community?

Customer owned ADIs are vastly different to listed ADIs.

By their very nature, a customer-owned bank is in a mutually supportive relationship with its members who are generally members of a geographic community or specific occupational community such as teachers, police officers, nurses, soldiers etc. Profits of these organisations are reinvested for the benefit of all members. The whole reason for the organisation's existence is to serve their members and community.

The importance of this sector of ADIs cannot be assessed through pure financial analysis alone. The contribution to communities in terms of employment in regional areas, charitable contributions, accessibility and often a unique and deep understanding of the community they serve is often overlooked. Customer owned ADIs tend to have a more personalised level of customer service that many of their members value. Fundamentally, the goals of the customers, as owners, are the goals of the institution.

During the Royal Commission hearings this year, there have been case studies which has highlighted a disconnect between the larger banks and their customers. There have been countless stories of the drive for profit at the expense of satisfactory outcomes for customers. Yet, it may transpire that regulation resulting from the outcomes of the Royal Commission, are applied using a "broad brush", impacting all ADIs including those whose whole basis is already for the benefit of their customers.

Customer owned v big banks

How are they different?

Smaller ADIs
Customer owned

- Customer owned
- Profits returned to members
- Democratically controlled by members
- Personalised customer relationships
- Invested in their local communities
- Servicing smaller and regional communities
- Smaller range of products and services

Larger ADIs
The big banks

- For Profit
- Profits go to shareholders
- Controlled by paid officials
- Headquartered in major cities
- Larger range of products and services

"A political argument: regulation should recognise the social role that small institutions play in facilitating access to credit – and financial services more generally – by households and small firms and their contribution to the development of local and regional economies."

Mr Fernando Restoy, Chairman, Financial Stability Institute, Bank for International Settlements, Keynote for Westminster Business Forum: Building a resilient UK financial sector – next steps for prudential regulation, structural reform and mitigating risks

Read full speech

While it is essential that all ADIs are held to the same principles of fairness, quality and customer service, what must be queried is what value should be placed on customer owned ADIs and their contribution back to their communities – in the form of reinvestment in the community, support for local people and businesses and more time spent creating long-term relationships over generating profits – and how this can be factored in to mitigating the burden of regulation.

How customer owned ADIs support local communities

Customer owned ADIs often undertake community activities in regional areas and provide much needed support to the communities they serve

- **Educational scholarships to support the future of their industry**
- **Charitable donations to local community groups**
- **Loan of EFTPOS terminals to community groups**
- **Financial literacy training**
- **Workspaces and mentoring to support local entrepreneurs**
- **Purchase of land to develop wildlife conservation areas**

It comes down to giving Australians real choice

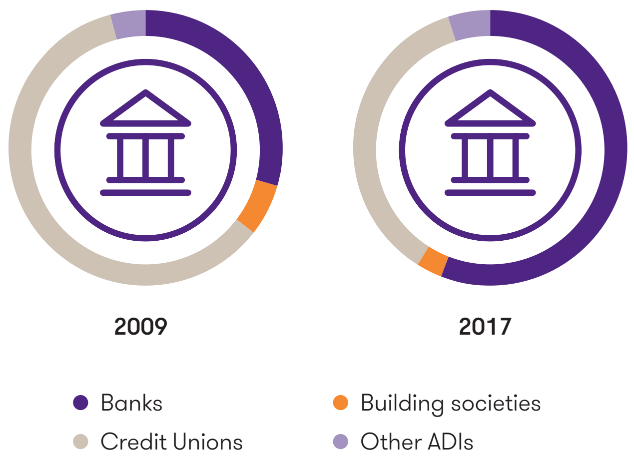
There has been a decline in the total number of ADIs operating in Australia, from 193 in 2009 to 147 in 2017.

This has largely been as a result of the decrease in the number of credit unions following consolidation and merger activity. Of the 147, four major banks hold approximately three quarters of the assets held by ADIs in Australia.

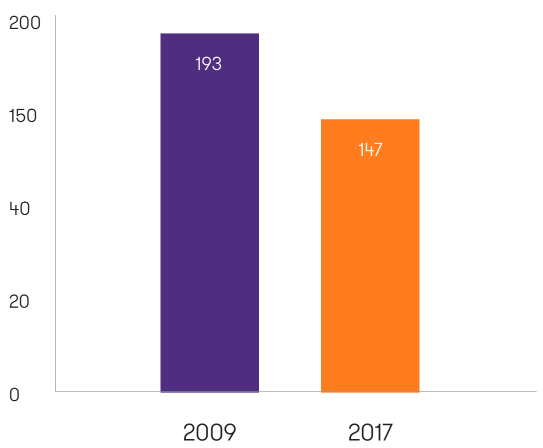
A driver of the decline in the number of credit unions has been the trend for credit unions to convert and rebrand to mutual banks. Additionally, the move towards consolidation to seek economies of scale to improve competitiveness has also caused this number to decrease.

While consolidation and merger activity enables smaller ADIs to leverage a larger customer base in order to achieve economies of scale and improve their competitiveness it can ultimately result in reduced diversity in the banking market. If ongoing consolidation of smaller ADIs continues, consumers will inevitably feel the effects of reduced consumer choice and less personalised community based services as product offerings and services become more homogenised.

Banking diversity[7]



Number of all ADIs



7. APRA Annual reports, https://www.apra.gov.au/annual-reports

"Bad behaviour is more likely to be 'punished' in competitive markets. The more alternatives consumers have, the greater their ability to avoid bad behaviour. The more firms in the market and the lower the barriers to entry, the greater the imperative for companies to look after their customers."

ACCC chair Rod Sims said in a speech on 13 July 2018

There needs to be an appropriate balance between stability and competition. Undoubtedly, in terms of ease of supervision a small number of banks would make life easier for regulators. But a smaller number of banks will likely fail to deliver best options and outcomes for customers and the communities they serve. It is the relationships fostered by customer owned banks that make these institutions powerful and valuable. It is the reinvestment in the community and their social benefit that is being eroded as smaller ADIs and customer owned banks are forced to merge for commercial reasons and the undue pressure from the increased demands of regulation.

"I am very convinced that proportionality is important – for several reasons:

- it ensures fair competition on a level playing field
- it prevents the unwanted side-effect of structural policy through regulation
- it strengthens the principle of risk-oriented supervision
- it prevents regulation from unnecessarily hampering efficiency.

All in all, I think that proportionality is necessary to safeguard the original goals and spirit of the Basel framework."

Andreas Dombret – Member of the Executive Board of the Deutsche Bundesbank – Speech to the Central Bank

Read full speech

Preparing for the inevitable

As the Royal Commission continues into its last few rounds, and Australia grapples with the magnitude of skeletons running from the closets of some of Australia's most 'trusted banks', we are left wondering what will all of this mean and how can we ensure that the future of Australia's banking sector is both fair to consumers and allows for diversity of choice?

We have to wait and see what will materialise. But, the one thing we can be certain of, is that there will be a change in regulation. The most probable form will be an increase in reporting and compliance obligations bringing focus to customer outcomes and areas which were not previously under such scrutiny from the regulators. The question is whether this will be applied across all institutions proportionately.

Regulation should be tailored to the size, complexity and risk profile of an institution. In particular, when considering future conduct regulation in light of the outcomes of the Royal Commission, understanding how the needs of a customer are prioritised by an ADI is key.

A possible unintended consequence of increased regulation, which is targeted at ensuring satisfactory outcomes for customers, is that it is implemented in such a way that it harms the very institutions which have had the customers at the heart of their businesses all along.

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Madeleine is focused on helping small and medium sized financial organisations grow and prosper. She has over 25 years of financial services industry experience, including ADIs, General Insurers, Health Insurers, Superannuation Funds, Asset Managers, brokers, dealers and their associated risk management, regulatory & compliance obligations.

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Darren's approach is to balance the needs of clients, regulators and the board, while remaining independent and commercial. He has been the trusted audit partner for organisations including BUPA's Australian and New Zealand operations, ANZ, NAB, Japara, La Trobe Financial Services, The Salvation Army and the Victorian insurance agencies, TAC and WorkSafe.

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Kat is passionate about conduct, culture and governance in the financial services sector. She is a skilled risk manager and internal auditor. Kat joined Grant Thornton in January 2018 from APRA where she supervised two major banking groups. Prior to this she spent more than 10 years in the UK which included three years at Deloitte where she assisted financial services clients navigate the regulatory changes following the GFC.

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